May 24, 2019

The Honorable Gavin Newsom
Governor, State of California
State Capitol Building, First Floor
Sacramento, CA 95814

RE: Proposed Budget Trailer Language: Section 1031 Limitation on Like-Kind Exchanges Tax Conformity – OPPOSE

Dear Governor Newsom:

The members of the Association of Global Automakers (www.globalautomakers.org) and the Alliance of Automobile Manufacturers (www.autoalliance.org) are writing to inform you of our **strong opposition** to your Administration's proposal to no longer allow like-kind exchange ("LKE") treatment for tangible personal property, including vehicles. We understand that the LKE proposal is an element contained within the Administration's overall budget proposal intended to raise revenue by "conforming" California's tax law to certain changes recently made in the federal Internal Revenue Code ("IRC"), as enacted as part of the 2017 federal "Tax Cuts and Jobs Act of 2017" (the "TCJA").

Though this proposal has been labeled as "conformity," that is not entirely the case. While the TCJA did in fact repeal traditional like-kind exchange treatment for business-related personal property exchanges, it also packaged that repeal with the adoption of first-year expensing for the acquisition of such personal property – which this proposal does not adopt. In practice, Congress replaced one type of tax benefit with another, recognizing that the bill's new expensing provisions would accomplish many of the same purposes as the traditional like-kind exchange tax treatment. The Administration's proposal chooses to conform to only half of the package, which undermines the policy goal envisioned by Congress, thereby making the state and federal tax codes less harmonious. As detailed below, the result of this action is a substantial tax increase on automakers. While we do not object to the larger policy goal of expanding the state's Earned Income Tax Credit (EITC), we believe it is unfair to ask one industry to shoulder such a disproportionate burden in doing so.

The elimination of LKE without the conforming first year expensing provisions hits our member companies especially hard because of their substantial leasing business. The popularity of leasing has increased as consumer behavior around car purchases is changing. Car technology is evolving more rapidly than ever before and is impacting electric vehicle advances and safety sensors, as well as creating opportunities for more personalized vehicle interactions using smartphones. When one includes the surge in ridesharing and the prospect of autonomous driving, the ever-growing popularity of leasing may indeed reflect buyers' increasing reluctance to commit to new car purchases for vehicle models that may well be outdated in three years. Such leasing options would

be less attractive to California's consumers as a result of the elimination of LKE, thereby undermining important public policy objectives. For example, higher priced leases could discourage customers from trying electric and other low- or zero-emission vehicles, particularly if they are reluctant to make a long-term purchase commitment.

From a tax policy perspective, Global Automakers and the Alliance strongly oppose the Administration's LKE proposal for the following reasons:

The LKE proposal will hurt reinvestments in California and increase costs for consumers. Internal Revenue Code Section 1031 (LKE) incentivized investment by enabling the re-investment of pre-tax capital which has the impact of lowering the cost of capital. In the automobile leasing business, LKE incentivized maintaining strong investment in lease assets and also made leasing more economical for consumers because the lower cost of capital could be passed on in the form of a lower lease payment. If LKE is repealed, leasing companies will be forced to pass the added cost of capital onto their customers, thereby resulting in increased monthly lease payments, which benefits neither California's consumers nor the automobile industry as a whole since sales will also be adversely impacted.

The elimination of LKE is not true tax conformity and enacts a substantial and inequitable tax increase on auto manufacturers. As stated previously, the elimination of LKE fails to conform to the TCJA, which mitigated the repeal of LKE treatment by also enacting full expensing, in the form of 100 percent bonus depreciation, for assets placed in service after September 28, 2017 and before January 1, 2023. In economic terms, full expensing has the same effect on lowering the cost of capital as did LKE. Thus, from a federal perspective, full expensing is as robust an investment incentive as was LKE, thereby enabling consumers to continue enjoying the benefit of more economical leasing.

The LKE proposal significantly and disproportionately impacts a small segment of the auto manufacturing industry. A handful of auto manufacturers will be especially and disproportionately impacted by the LKE changes proposed by the Administration. Collectively, the impact on these companies over the first three year period represents a tax increase of $360 million dollars, or an average of $120 million per year over the first three years. Furthermore, applying that $120 million on average dollar figure to the total amount of revenues that Administration has stated it expects to receive in the first year ($260 million in Fiscal Year 2019-2020), these handful of companies would be expected to contribute more than 46 percent of the total revenues that the Administration expects to see realized under LKE.

Consequently, while we agree that expanding tax credits for California's working families is a worthwhile policy goal, and we understand the Administration's desire to realize revenues sufficient to offset the proposed expansion of the state's EITC, it is unreasonable to expect a small number of companies in one industry to carry such a large proportion of the burden—as would be the case if LKE is eliminated—to help fund the proposed credit.

For the above reasons, Global Automakers and the Alliance must oppose the Administration's LKE proposal as it is currently conceived. We look forward to engaging in a constructive dialogue with you.

Sincerely,

Damon Porter
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Association of Global Automakers

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Senior Manager, State Government Affairs
Alliance of Automobile Manufacturers

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